Opinion No. 1214

SUPERIOR COURT OF THE DISTRICT OF COLUMBIA

Tax Division

SUPERIOR COURT OF THE DISTRICT OF COLUMBIA TAX DIVISION

JAN 31 1983

FILED

McLEAN GARDENS CORPORATION, (formerly CBI Fairmac Corporation),

Petitioner,

v.

DISTRICT OF COLUMBIA,

Respondent.

Tax Docket No. 3158-82

ORDER

For the reasons set forth in this Court's Opinion and Order entered this date, it is now, therefore,

ORDERED, that Petitioner's Motion for Summary Judgment be, and hereby is, granted; and that Respondent's Cross-Motion for Summary Judgment be, and hereby is, denied; and it is

FURTHER ORDERED that Respondent District of Columbia refund to Petitioner the amount of $225,664 for tax overpayments for the year 1977 and $107,094 for tax overpayments for the year 1978, with interest as provided by D.C. Code §47-3310(c) (1981 ed.).

JUDGE IRALINE G. BARNES

Dated: January 31, 1983

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OPINION AND ORDER

This matter came before the Court on November 16, 1982, on Cross-Motions for Summary Judgment. The taxes in controversy are District of Columbia franchise taxes assessed against the petitioner pursuant to D.C. Code 1981 §47-1807.1 and 1810.2 in the amounts of $225,664.00 for tax year 1977, and $107,094.00 for tax year 1978. The assessment results from the District's determination that the petitioner was a unitary business and its use of a "three factor formula" to determine the petitioner's taxable income. The petitioner's administrative claim for a refund was denied, and the petitioner paid the disputed taxes and statutory interest on January 14, 1982.

This Court has jurisdiction to hear this appeal pursuant to D.C. Code 1981 §§11-1201 and 47-3303.

I.

The Petitioner, McLean Gardens, claims that the Respondent District of Columbia improperly combined the property, payroll and sales components (the three factor formula) of two separate corporations, McLean Gardens in the District and Fairlington Village in Virginia, in order to determine McLean Gardens' taxable income. The Petitioner alleges that McLean Gardens, which operates solely in the District, is a business entity that is entirely separate from Fairlington Village, which operates solely in Virginia. The Petitioner contends therefore that the District's decision to tax McLean Gardens-Fairlington Village as a unitary business

violated D.C. tax statutes and regulations and resulted in double taxation (taxation of the same income by both the District and The Commonwealth of Virginia) repugnant to the Due Process Clause and the Commerce Clause of the United States Constitution. The District claims, on the other hand, that McLean Gardens and Fairlington Village shared business operations to the extent that an economy of scale was achieved, resulting in a unitary business for taxation purposes. Therefore, the issue before the Court is whether the District correctly determined that McLean Gardens-Fairlington Village was a unitary business, and thus properly applied the three factor formula to the unitary business for the purpose of determining the taxable income of McLean Gardens. After careful consideration of the pleadings and records of the case, and the arguments of counsel, the Court has concluded that McLean Gardens and Fairlington Village are separate businesses requiring separate taxation. Finding that the District acted improperly, the Court grants the Petitioner's Motion for Summary Judgment.

II.

The material facts of this case are not in dispute, and may be briefly summarized:

1. In 1972, Petitioner, formerly known as CBI New Fairmac Corporation and CBI Fairmac Corporation, acquired the assets of three corporations: McLean Gardens Corporation, North Fairlington Corporation, and South Fairlington Corporation. The primary asset of McLean Gardens Corporation was an apartment complex located in the District of Columbia and commonly known as McLean Gardens. North Fairlington Corporation and South Fairlington Corporation each owned a portion of an apartment complex located in Arlington, Virginia, and commonly known as Fairlington Village. The Petitioner maintained its corporate address at 3118 South Abingdon Street, Arlington, Virginia.

2. After the acquisition of the Fairlington Village complex, Petitioner immediately engaged in an extensive and comprehensive rehabilitation and remodeling project in order to convert the apartments

in the complex to individual condominium units which could be sold as quickly as possible. Because of the size of Fairlington Village, remodeling of all buildings could not be undertaken simultaneously. Accordingly, some of those buildings which had not yet been remodeled and converted to condominiums were kept available for tenants who wished to remain pending conversion of their units.

3. The employees hired to perform the renovation and remodeling activity at Fairlington Village were employed solely in Virginia and performed no services in connection with the District of Columbia business at McLean Gardens.

4. During the conversion at Fairlington Village, the business conducted by Petitioner at McLean Gardens continued its historic operation as an apartment rental complex. That business employed its own staff at McLean Gardens for janitorial, maintenance, cleaning and maid service, as well as for rental operations and other support activities. The supervisor of maintenance at McLean Gardens and the supervisor of the staff of the McLean Gardens business maintained their only offices on the site. They had the exclusive authority to hire and fire the employees they supervised. The only assistance provided by Virginia-based employees consisted of accounting services and upper management level decisions on special policy matters such as zoning and rent control litigation. Personnel employed at the McLean Gardens business in the District of Columbia provided no services and in no way assisted in the operation of the business conducted at the Fairlington Village complex in Virginia.

5. Petitioner provided a hospitalization plan for the employees of its Virginia business through Group Hospitalization, Inc., Washington, D.C. All premiums were paid by Petitioner. Petitioner did not provide a hospitalization plan for the employees of its District of Columbia business. However, it did permit those employees, at their own expense, to join the plan for the Virginia employees.

6. The same insurance company and agency provided coverage for both Petitioner's Virginia business and its District of Columbia business.

7. Various payroll and general accounts were maintained by Petitioner at the Alexandria National Bank in connection with its District of Columbia business and its Virginia business, and the two officers of the Petitioner were the signators on each of these accounts.

8. Because of the geographic separation and independent operation of the McLean Gardens and Fairlington Village businesses, Petitioner from its inception continuously used an accounting system which separately identified each item of earned income as having been earned either at McLean Gardens or at Fairlington Village. This accounting system also specifically allocated the majority of all expenses incurred to either McLean Gardens or Fairlington Village. Only a small fraction of the two businesses' expenses and deductions were combined and apportioned between the District and Virginia. This fraction represented bookkeeping and administrative services, and limited supervision provided for McLean Gardens by personnel located in Virginia.

9. The petitioner had no gross income earned from any trade or business being conducted both within and without the District of Columbia.

10. Beginning with its incorporation in 1972, Petitioner consistently used the separate accounting system as the basis for filing its annual District of Columbia franchise and Virginia income tax returns. For the years through 1976, the District raised no objection to Petitioner's use of its separate accounting system as the basis for filing its tax returns.

11. The Petitioner also used this separate accounting system for the filings it made with the District of Columbia Rental Accommodations Office. The District of Columbia Rent Control Law limited the maximum amount of rents that could be charged at McLean Gardens. The effect of that law is reflected in the reduced net income of the McLean Gardens business for 1977 and 1978.

12. Although there was a significant deficit from the District of Columbia business in 1978, on an overall basis (1972-1979) there was not a cash flow deficit from the District of Columbia business. In 1978, rather than borrow funds to fund the deficit in the District of Columbia business, Petitioner utilized funds generated by its Virginia business to pay some of the expenses of the District of Columbia business.

13. On October 12, 1978, Petitioner filed its 1977 franchise tax return with the District of Columbia. This return recorded as net income earned within the District of Columbia all of the gross income which Petitioner derived from its trade and business at the McLean Gardens complex, less the expenses incurred in earning that income, computed in accordance with the separate accounting system. The franchise tax on Petitioner's resulting net income was $37,587 less than the estimated tax payments made for 1977, and on its franchise tax return Petitioner claimed a refund of this overpayment. By amended return for 1977 dated September 23, 1980, this claim for refund was increased to $41,003 as a result of Federal income tax audit adjustments. By letter on behalf of Petitioner dated June 10, 1981, it was further claimed that interest income from passive investments unrelated to the McLean Gardens business which had been originally apportioned between the District of Columbia and Virginia on Petitioner's 1977 District of Columbia tax return should have been reported solely as Virginia income because the domicile of Petitioner was Virginia. This further claim resulted in the final claim for refund for 1977 being increased to $43,709.

14. On October 12, 1979, Petitioner filed its 1978 franchise tax return on which a refund of tax overpayments of $33,000 was claimed. This tax return recorded as net income earned within the District of Columbia all the gross income derived from Petitioner's trade and business at the McLean Gardens complex less the expenses incurred in earning that income computed in accordance with the separate accounting

system. On September 23, 1980, Petitioner filed an amended 1978 franchise tax return which did not change the amount of the refund claimed.

15. The income tax returns filed in Virginia by Petitioner in 1977 and 1978 recorded as net income earned within Virginia all the gross income earned by Petitioner's trade and business in Virginia in those years less the expenses incurred in earning that income computed in accordance with the separate accounting system. Petitioner paid taxes at the statutory rate on the resulting net income.

16. In 1981, Petitioner's tax returns for 1977 and 1978 were audited by the Audit Division of the District of Columbia Department of Finance and Revenue. At the conclusion of the audit, the Department combined Petitioner's Virginia and District of Columbia net income, applied a three-factor formula to the total net income, and concluded that Petitioner had taxable income attributable to its trade and business in the District of Columbia in the amounts of $1,731,396 for 1977 and $893,095 in 1978. For the same years, the gross rentals received from McLean Gardens were only $1,758,494 and $964,378, respectively.

17. As a result of the action taken by the Department of Finance and Revenue, the District of Columbia rejected Petitioner's claims for tax refunds of $4[illegible],709 for 1977 and $33,000 for 1978. The District assessed additional tax which, with interest, totaled $181,875 for 1977 and $74,119 for 1978. The Petitioner paid the additional assessments on January 18, 1982. The payments resulted in a total claimed overpayment by Petitioner of $225,664 for 1977 and $107,094 for 1978.

III.

Petitioner argued that application of the three-factor formula in this case violated (A) the D.C. Code, (B) the D.C. Franchise Tax Regulations, and (C) the Due Process Clause and Commerce Clause of the United States Constitution. The Respondent argued that it had correctly determined that McLean Gardens-Fairlington Village was a unitary business, and thus that application of the three-factor formula to the

combined business income was a proper method by which to gauge McLean Gardens' liability for D.C. franchise taxes for 1977 and 1978.

A. The District of Columbia Code imposes a franchise tax on the "taxable income" of a corporation and "taxable income" is defined as "the amount of net income derived from sources within the District." D.C. Code 1981 §§47-1807.1 and .2. The Court finds that the petitioner derived its income from two separate sources or businesses--one within the District of Columbia (McLean Gardens) and one wholly without the District of Columbia (Fairlington Village). The operations of each business were conducted by separate staffs which performed different types of functions. Each of the businesses was completely independent except for a minimal amount of supervisory services relating to zoning and rent control litigation and accounting services provided to McLean Gardens by Fairlington Village personnel.

The Respondent contends, however, that as a result of the minimal services provided to the District of Columbia business by employees of the Virginia business, advantages of economy of scale were achieved netting a unitary business. There is no factual support in the record for the assertion that any such advantages of economy of scale were achieved. Moreover, even if minimal economies of scale had been achieved, that would not, given the other facts of this case, transform the two separate businesses which were conducted by Petitioner into one, unitary business.

The income earned in the District of Columbia by the McLean Gardens business was "derived from sources within the District" and there is no dispute that District taxes may be imposed on such income. However, the income earned in Virginia by the Fairlington Village business was not "derived from sources within the District." It was earned in Virginia and income taxes were paid in Virginia with respect to such income. Accordingly, this Court holds that the Department of Finance and Revenue acted in violation of D.C. Code 1981 §47-1807.1 in seeking to tax Petitioner's Virginia income.

B. Section 309.2 of the D.C. Income Tax and Franchise Tax Regulations provides, in relevant part:

> The measure of the franchise tax shall be that portion of the net income of a corporation . . . as is fairly attributable to any trade or business carried on or engaged in within the District . . . .

The regulations further provide that, if the three-factor formula does "not fairly represent the extent of the taxpayer's trade or business in the District" separate accounting may be used. D.C.R. & Regs. Tit. 16 §309.5(j). These regulations are modeled after the Uniform Division of Income for Tax Purposes Act which has been adopted in over 35 states, and these provisions, or similar provisions, have been repeatedly construed to endorse the use of separate accounting in situations such as the present one. See: Comptroller v. Diebold, Inc., 279 Md. 401, 369 A.2d 77 (1977); A.E. Druggemann & Co., Inc. v. State Tax Commission, 42 A.D. 2d 473, 349 N.Y.S.2d 28 (Sup. Ct. 1973); People ex rel. Sheraton Buildings, Inc., Relator v. Tax Commission, 15 A.D.2d 142, 222 N.Y.S.2d 192 (Sup. Ct. 1961). See also: Commonwealth v. Advance-Wilson Industries Inc., 456 Pa. 200, 317 A.2d 642 (1974).

The imposition of rent controls and the high costs incurred in operating McLean Gardens resulted in a net income of only $617 in 1977 from McLean Gardens and in 1978 Petitioner incurred a net loss of $718,197 from McLean Gardens--resulting in a total net loss for both years in excess of $700,000. By application of the three-factor formula, however, the Department sought to charge Petitioner with a net income from within the District of $1,731,396 for 1977 and $893,059 for 1978, even though the unadjusted gross rental collections from McLean Gardens totaled only $1,753,494 in 1977 and $964,378 in 1978. The Department's use of the three-factor formula thus generated a net income figure equal to 98.4% of the gross income earned by McLean Gardens during 1977 and 92.6% of such gross income during 1978.

The Respondent does not contest that such would be the effect of applying the three-factor formula to McLean Gardens-Fairlington Village

as a unitary business. The Respondent relies on District of Columbia v. Pierce Associates, 440 A.2d 325 (D.C. App. 1981) for the proposition that application of the three-factor formula for determining taxable income is appropriate in the instant case. Pierce involved facts strikingly disimilar to the facts presented by the instant case, and thus does not control this Court's disposition of the issue. In Pierce the taxpayer was a mechanical contractor conducting a unitary business in the District, Maryland and Virginia. The taxpayer did not keep separate accounts of income and expenses solely applicable to the different jurisdictions. Thus, the Court of Appeals concluded, the District's use of the three-factor formula was the proper method by which to determine the "amount of income allocable to the District business" and thus subject to D.C. franchise tax.

Here, the Petitioner McLean Gardens is a business entirely separate from the Fairlington Village business. The Petitioner maintains a separate accounting system which demonstrates that the McLean Gardens business is conducted wholly within the District and that the Fairlington Village business is conducted wholly without the District. Because of the Petitioner's longstanding use of the separate accounting system, the District had no need to use the three-factor formula to determine the proper apportionment of income from sources within and without the District. The separate accounting system made any such theoretical apportionment unnecessary. Thus Pierce's approval of the three-factor formula in cases where a separate accounting system is not maintained does not apply to the present situation.[1/]

Under all the circumstances, even if the income from the Virginia business could be included within Petitioner's tax base for purposes of calculating the District franchise tax, the application of the three-

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1/ The Court also notes that the D.C. Court of Appeals holding in Pierce that the District may tax nonbusiness income only if the taxpayer's commercial domicile is within the District supports this Petitioner's exclusion of interest income from passive investments unrelated to McLean Gardens in tax year 1977.

factor formula to the Petitioner would not "fairly represent the extent of the taxpayer's trade or business in the District." This Court thus holds that application of the three-factor formula in this case violates Reg. §309.2 and §309.5(j) and that Reg. §309.5(j) requires, instead, the use of separate accounting.

C. In Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931), the Supreme Court established the principle that if application of an apportionment formula in a particular case results in "attributing to [a State] a percentage of income out of all appropriate proportion to the business transacted in that State," such application violates the Due Process Clause. The application of the three-factor formula in the present case turns $617 of net income in 1977 and a $718,197 loss in 1978 into taxable income of $1,731,396 in 1977 and $893,049 in 1978 and, thereby, results in Petitioner realizing taxable income in 1977 equal to 98.4% of the gross rentals collected from McLean Gardens in that year and in 1978 equal to 92.6% of the gross rentals from McLean Gardens.

The Respondent, however, relies on Butler Bros. v. McColgan, 315 U.S. 501 (1942) for the proposition that the conversion of a loss into a profit through use of the three-factor formula is proper. Butler Bros. involved a chain of wholesale establishments which were operated as one business. The California store made sales of $5,206,000 during 1935 and, on a separate accounting basis, reported a tax loss of $82,851 for California tax purposes. The California tax authorities applied the three-factor formula and determined a tax profit of some $93,500. The Supreme Court held that a tax on a unitary business equal to less than 4% of the gross receipts of the California store, did not violate the Due Process Clause. In contrast, in the present case the application of the three-factor formula results in an increase in taxable income equal to over 90% of the McLean Gardens gross receipts in 1977 and to approximately 167% of such receipts in 1978. Under all the circumstances, this Court holds that application of the three-

factor formula in this case violates the Due Process Clause of the Fifth Amendment because it attributes to the District income out of all appropriate proportion to the business of the Petitioner transacted in the District of Columbia.

In both Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980) and Exxon Corporation v. Wisconsin Department of Revenue, 447 U.S. 207, 227-228 (1980), the Supreme Court stated that, in determining whether the Commerce Clause is violated by application of the three-factor formula, a court must

> examine the "practical effect" of the tax to determine whether it is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state.

447 U.S. at 227, 228. In the present case the application of the three-factor formula does not fairly apportion income to the District of Columbia. Moreover, Petitioner paid its Virginia taxes on its Virginia business and application of the three-factor formula by the District of Columbia would result in actual double taxation of approximately $1.7 million of income in 1977 and approximately $900,000 of income in 1978. Under such circumstances, this Court holds that the practical effect of the application of the three-factor formula is to burden interstate commerce in violation of the Commerce Clause.

IV.

This case presents a question of interpretation of a set of undisputed facts. The Court has carefully weighed all the facts, particularly the historic use of a separate accounting system, and has concluded that McLean Gardens and Fairlington Village are separate businesses. Therefore, the Respondent's decision to tax the income of McLean Gardens by applying the three-factor formula to McLean Gardens-Fairlington Village as a unitary business was improper.

Based upon the foregoing findings of facts and conclusions of law this Court has determined that Petitioner's Motion for Summary Judgment, should be granted and Respondent's Cross-Motion for Summary Judgment should be denied. The Court will direct Respondent District of Columbia to refund to Petitioner the amount of $225,664 for tax overpayments for the year 1977 and $107,094 for tax overpayments for the year 1978, with interest as provided by D.C. Code §47-3310(c) (1981 ed.).

JUDGE IRALINE G. BARNES

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